Office of Chief Counsel
Internal Revenue Service
memorandum

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to: Associate Area Counsel, Large Business & International (Area 1) CC:LB&I
Attn: Joshua Nachman, CC:LB&I:F:LI

from: Branch 7, Office of Associate Chief Counsel, Income Tax and Accounting (CC:ITA:B07)

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subject:

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Taxpayer =

b =

c =

d =

e =

f =

ISSUES

(1) Whether Taxpayer may treat as an adjustment to cost of goods sold the costs of b it provides to customers in a bargained-for exchange.

(2) If Taxpayer may not treat the costs of b as an adjustment to cost of goods sold, are deductions for the costs of b subject to the disallowance provisions of § 274 of the Internal Revenue Code (Code)

CONCLUSION

(1) Yes. Taxpayer may treat the costs of b as an adjustment to cost of goods sold.

(2) Because Taxpayer may treat the costs of b as an adjustment to cost of goods sold, issue (2) is moot.

FACTS

Taxpayer, a c company, is engaged in the d publication and distribution of e media for f. Taxpayer’s customers are generally advertisers that pay to include their products in the print media and other advertising. Taxpayer established an added value merchandising program under which it purchased b and paid related companies to provide suite accommodations and catering services to the ultimate b holders. Taxpayer also provided customers with merchandising allowances or points to acquire b at a later date. The cost of these items generally constituted no more than twenty-five percent of the order placed. Taxpayer treated these expenditures as an adjustment to its cost of goods sold. The revenue agent determined that Taxpayer should have deducted the expenditures from its gross income under § 162, subject to the limitations of § 274.

LAW AND ANALYSIS

Generally, except as otherwise provided in the Code, gross income means all income from whatever source derived. I.R.C. § 61(a). The Supreme Court has long recognized that the definition of gross income sweeps broadly and reflects Congress’ intent to exert the full measure of its taxing power and to bring within the definition of gross income all accessions to wealth. *Commissioner v. Schleier*, 515 U.S. 323, 327 (1995).

Purchase price adjustments and rebates are not within the definition of income. Generally, when a seller refunds or rebates part of the purchase price of goods or services to a customer as an inducement to purchase, the payment does not constitute an expense to the seller or income to the purchaser. It is an adjustment to the price of the service or property sold.

There is a fundamental difference between expenditures that constitute refunds and rebates (also known as "returns and allowances") and expenditures that are treated as business deductions under § 162. *Max Sobel Wholesale Liquors v. Commissioner*, 630 F.2d 670, 671-672 (9th Cir. 1980), *affg* 69 T.C. 477 (1977). The cost of goods purchased for resale in a taxpayer's trade or business is subtracted from gross receipts to compute gross income. Treas. Reg. § 1.61-3(a) of the Income Tax Regulations. These offsets do not constitute deductions and are not subject to the various limitations on deductions pertaining to § 162. *Metra Chem Corp. v. Commissioner*, 88 T.C. 654, 661 (1987). Since we conclude that the expenditures at issue constitute purchase price adjustments, the provisions of §162 are inapplicable and need not be addressed. *See Metra Chem Corp*.

The seminal case in this area is *Pittsburgh Milk Co. v. Commissioner*, 26 T.C. 707 (1956), *nonacq.* 1959-2 C.B. 8-9, *nonacq. withdrawn and acq.* 1962-2 C.B. 5-7, *acq. withdrawn and nonacq.* 1976-2 C.B. 3-4, and *nonacq. withdrawn in part and acq. in part* 1982-2 C.B. 2, where a dairy wholesaler paid cash rebates to customers under an informal arrangement to avoid state minimum milk pricing regulations. The court concluded that allowances the milk producer paid to buyers lowered the selling price of the milk for income tax purposes and held that only the net price was includable in the seller's gross income. The court stated:

> It does not follow, of course, that all allowances, discounts, and rebates made by a seller of property constitute adjustments to the selling prices. Terminology, alone, is not controlling, and each type of transaction must be analyzed with respect to its own facts and surrounding circumstances. Such examination may reveal that a particular allowance has been given for a separate consideration – as in the case of rebates made in consideration of additional purchases of specified quantity over a specified subsequent period; or as in the case of allowances made in consideration of prepayment of an account receivable, so as to be in effect a payment of interest. The test to be applied, as in the interpretation of most business transactions, is: What did the parties really intend, and for what purpose or consideration was the allowance actually made? Where, as here, the intention and purpose of the allowance was to provide a formula for adjusting a specified gross price to an agreed net price, and where the making of such adjustment was not contingent upon any subsequent performance or consideration from the purchaser, then, regardless of the time or manner of the adjustment, the net selling price agreed upon must be given recognition for income tax purposes. *Pittsburgh Milk*, at 717.

In Rev. Rul. 2005-28, 2005-1 C.B. 997, the Service held that Medicaid rebates incurred by a pharmaceutical company are purchase price adjustments that are subtracted from gross receipts in determining gross income. In so holding, the Service relied on *Pittsburgh Milk*, noting the following:

> The court focused on the facts and circumstances of the transaction, what the parties intended, and the purpose or consideration for which the allowance was made. The court found that the allowances were part of the sales transaction and concluded that gross income must be computed with respect to the agreed net prices for which the milk was actually sold. Thus, under *Pittsburgh Milk*, where a payment is made from a seller to a purchaser, and the purpose and intent of the parties is to reach an agreed upon net selling price, the payment is properly viewed as an adjustment to the purchase price that reduces gross sales.

The facts in this case fall squarely within the parameters of Rev. Rul. 2005-28[1]. It is undisputed that Taxpayer agreed to provide and the purchasers agreed to accept both printed advertisements and b or points for a single price. The fact that Taxpayer may incur the expense to acquire the b after it executes the contract with the purchaser is not legally significant under *Pittsburgh Milk*. Similarly, whether a rebate is payable in merchandise or in cash doesn't matter. The result is the same. *Max Sobel Wholesale Liquors*, 69 T.C. at 481. The determinant facts are that the purchaser and Taxpayer negotiated over the amount of b or merchandising allowances or points that would be an integral part of the sale and the adjustment was not contingent on any subsequent performance or consideration from the purchaser.

Since the costs of b which Taxpayer provides to customers are to be treated as cost of goods rather than business expenses deductible under § 162, the costs also are not subject to the limitations of § 274. *Metra Chem Corp., 88 T.C. at 661.*

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[redacted]

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call (202) 317-4718 if you have any further questions.

/s/ Willie Armstrong

By: ______________________________

WILLIE E. ARMSTRONG, JR.
Senior Technician Reviewer, Branch 7
(Office of Associate Chief Counsel, Income Tax & Accounting)

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[1] The Commissioner must follow his own relevant revenue rulings in Tax Court proceedings. *Rauenhorst v. Commissioner*, 119 T.C. 151, 170-173 (2002).

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